FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

DONALD E. POWELL
CHAIRMAN

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Mr. Richard Hillman, Director
Financial Markets and Community Investment
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Hillman:

Thank you for the opportunity to comment on the draft report entitled Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlights Differences in Regulatory Authority (GAO-05-621). Your report does not recommend executive action. However, we welcome this opportunity to respond to the report and address the Matters for Congressional Consideration that you have raised.

The Federal Deposit Insurance Corporation agrees with the report's finding that "from an operations standpoint, industrial loan corporations (ILCs) do not appear to have a greater risk of failure than other types of insured depository institutions." The report also documents the FDIC's legal and supervisory authorities to address risks to insured ILCs that may be posed by affiliated entities. The report nevertheless recommends that Congress consider strengthening (the report's term) the regulation of parent companies of ILCs by subjecting them to the same consolidated supervision as is currently applied to bank holding companies. The FDIC believes these suggested changes in regulation are unnecessary from a safety and soundness perspective, and would inappropriately change the relationship between the federal banking agencies and the non-bank sector of the U.S. economy.

As outlined in more detail in this letter, the FDIC does not believe that consolidated supervision of an ILC's corporate owner is necessary to ensure the safety and soundness of the ILC itself. The FDIC disagrees with the GAO's finding that our regulatory authorities may not be sufficient to effectively supervise, regulate, or take enforcement action to insulate insured institutions against undue risks presented by external parties. We believe the GAO's finding is founded on a misinterpretation of the legal basis underlying the regulatory authorities of both the FDIC and the Federal Reserve Board of Governors (Federal Reserve). The core of each banking agency's statutory mandate for supervision is preserving the safety and soundness of insured depository institutions. We believe the record shows the FDIC's authorities are as effective in achieving this goal as are the authorities of consolidated supervisors.

The FDIC also believes consolidated supervision of ILC parents would change the relationship between the federal banking agencies and the non-bank sector of the U.S. economy in undesirable ways. This includes the potential for an unintended expansion of the federal

banking safety net, and the costs of imposing bank-like regulation on a greater share of U.S. economic activity. The GAO bases its recommendations in part on the idea that ILCs benefit from an uneven competitive playing field, since their parent companies are not subject to the same type of consolidated supervision that applies to other corporate owners of insured banks. As noted by a number of panelists at a symposium the GAO convened to assist in the preparation of this report, however, there are reasons why commercial and other non-bank owners of insured banks should not be subject to consolidated banking agency supervision. Commercial firms and entities such as broker-dealers are, and should remain, outside the scope of the federal banking safety net. Imposing activity restrictions and other aspects of bank-like regulation on firms that historically have not been subject to such regulation has costs, and these costs need to be weighed against any perceived safety-and-soundness benefits to insured entities.

The necessity of consolidated federal supervision of all large conglomerates that own banks is a new idea. In March, 1997, Federal Reserve Chairman Alan Greenspan told Congress:

> ...we would hope that should the Congress authorize wider activities for financial services holding companies that it recognize that a bank, which is a minor part of such an organization (and its associated safety net), can be protected through adequate bank capital requirements and the application of Sections 23A and 23B of the Federal Reserve Act. The case is weak, in our judgment, for umbrella supervision of a holding company in which the bank is not the dominant unit and is not large enough to induce systemic problems should it fail.1 [Emphasis added].

More recently, proponents of consolidated supervision appear to have moved away from the views expressed by Chairman Greenspan and toward a more absolute claim that the safety and soundness of an insured financial institution requires the consolidated, top-down supervision of its corporate owner. This approach, which the GAO endorses, is based on the idea that supervisors should mirror business processes used in the private sector. Enterprise risk management processes, used by a number of large banking organizations, are characterized by a centralized approach to risk management throughout the conglomerate. Enterprise risk management, as used in these firms, is essentially a tool to better manage private profits and safeguard the interests of holding company shareholders. However, its use as a model on which federal bank supervisors would base their efforts to safeguard individual insured banks within large conglomerates is as yet unproven. Indeed, by appearing to promote the operation of insured entities in conglomerates more as integrated parts of a broader organization, and less as insulated entities, consolidated supervision going forward could have the unintended effect of extending the scope of the safety net, rather than containing it.

For these reasons, the FDIC believes that a supervisory approach that focuses on insulating the insured financial institution and the federal safety net from external risks (the bank-centric approach) is an appropriate supervisory model for ILCs and their parent companies.

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[1] Testimony of Chairman Alan Greenspan before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee on Banking and Financial Services, U.S. House of Representatives, March 19, 1997.

The remainder of this letter provides further discussion of the track record of supervision, the practical significance of differences in agencies' supervisory authorities, certain issues related to banking agency supervision of commercial firms, and the scope of the federal banking safety net.

The Track Record of Supervision

Surprisingly, in recommending one mode of supervision over another, the report attempts no comparison of how these methodologies have fared in protecting the deposit insurance funds, or their relative costs and benefits. Not only does the report attempt no systematic study of these issues, it ignores opportunities for relevant comparisons. For example, while acknowledging that the FDIC successfully insulated from failure the insured ILC of a large, bankrupt, commercial parent company, the report does not provide similar examples where a large bank holding company failed without any losses to its insured subsidiaries.

In the absence of any factual comparison of how various models of holding company supervision have fared in protecting the deposit insurance funds, the GAO report looks to a single ILC failure, Pacific Thrift and Loan (PTL), and repeats assertions by representatives of the Federal Reserve who speculate that excessive debt at PTL's parent caused the bank to engage in higher-risk strategies that resulted in the bank's failure. The assertions, however, are not supported by the FDIC Inspector General's Material Loss Review finding that, "PTL's overly optimistic valuation assumptions resulted in inflated values that were unrealizable." PTL did not fail as a result of parent company debt, and neither the Federal Reserve nor the GAO presents any evidence that an examination of the parent company by a consolidated supervisor would have prevented the failure of this insured institution. The Federal Reserve's assertions in this case are all the more surprising in view of the fact that it joined the FDIC and other bank regulators in responding to the failure of PTL and other non-ILC institutions by tightening the rules for valuations of residual assets, not by taking any action to address problems with excessive parent company debt.

The FDIC believes that bank-centric supervision, as applied by the National Bank Act and the FDI Act, and enhanced by Sections 23A and 23B of the Federal Reserve Act and the Prompt Corrective Action provisions of the FDIC Improvement Act, is a proven model for protecting the deposit insurance funds, and no additional layer of consolidated federal supervision of ILC parents is necessary.

The Legal Authority for Supervision

The FDIC's supervisory philosophy of insulating the insured ILC, bank, or thrift, is rooted in the absolute accountability of insured institution boards of directors for the governance of their institutions. Transaction testing at the insured entity, traced as needed through parent companies and affiliates, is intended to ensure that undue parent company influence is not being exercised. Important bank functions are evaluated onsite, whether at the bank or, where those functions are outsourced to affiliates, at those entities. Identifying and addressing inappropriate influence by affiliated entities is included in the scope of every examination, but the degree of insulation the FDIC requires increases substantially as identified risk increases, and can reach the

point where the bank is completely walled off from its affiliates with all major decisions requiring FDIC approval.

One of the central themes of the report is that the FDIC's authority to examine an affiliate of an insured depository institution is so restricted that reputation risk from an affiliate that has no direct relationship with the ILC could go undetected. Contrary to GAO's legal interpretation, the FDIC's affiliate examination authority is not dependent upon the existence of any particular kind of relationship, nor is it limited to discrete transactions between an ILC and its affiliate. The FDIC does not agree that its examination authority is properly interpreted so narrowly. In actual application, even in problem-institution or failure cases, the FDIC has always been able to exercise its examination authority broadly enough to fulfill its supervisory duties.

The GAO report points to perceived limitations on the FDIC's supervisory authority that might prevent it from exercising authority over certain non-banking affiliates. Yet, a careful reading of the report reveals that the authorities of consolidated supervisors are subject to almost identical limitations. Furthermore, the GAO report acknowledges an additional power available to the FDIC alone: "[a]s demonstrated by the number of institutions that took measures to enhance the safety and soundness of the insured depository institution, the threat of insurance termination has been an effective supervisory measure in many instances."

Whether in the case of a consolidated supervisor or the FDIC, the financial institution supervisor must rely on knowledge of a potential problem at a non-bank subsidiary and have some reason to believe that problem may adversely affect the insured depository institution before the supervisor can take direct action. The FDIC has an excellent track record of doing so even without the consolidated supervisory powers itemized in the report. In terms of the relevant goal of safeguarding the federal banking safety net, any conclusion that the FDIC's affiliate examination authority is less effective in practice than that of consolidated supervisors is not supported by the historical record.

Issues Associated with Banking-Agency Supervision of Commercial Enterprises

Consolidated supervision implies that a federal banking regulator would oversee the commercial parent and its affiliates, and that commercial activities increasingly would be subject to regulation designed for banks. The potential result of implementing the GAO's recommendation would be that federal banking regulators may exercise supervisory oversight over large sectors of the U.S. economy. This would represent a new level of government intrusion in the marketplace – in fact, it would amount to a radical restructuring of the longstanding role of the federal government relative to commercial firms. Such an approach also would raise significant concerns about legal separateness, corporate governance, and the unwarranted expansion of the federal safety net.

It should also be noted that consolidated supervision of a large, commercial organization is subject to certain practical constraints. The legal structures of many of these companies are intentionally segregated, with some large companies having hundreds of subsidiaries. Many financial holding companies are similarly diverse. An individual review of each subsidiary would be extremely time-consuming and would be unlikely to yield information useful to the

effective supervision of the subsidiary bank. As a result, consolidated supervisors have tended to focus on a high-level review as the only time-effective, practical approach to the supervision of these entities. The argument that consolidated supervision of a company such as General Electric would benefit bank regulators by improving familiarity with a non-bank affiliate, such as the consumer electronics division of the company, is not compelling from either a logistical or a risk identification standpoint.

The Consolidated Supervision Approach May Extend the Federal Safety Net

In the United States, the federal safety net is provided to insured banks, not their holding companies and affiliates. Preventing the federal safety net from supporting risks taken outside insured banks has been the most often-stated reason for the existence of bank holding company supervision.

Recently, however, the Federal Reserve endorsed the concept of enterprise-wide supervision, founded on the principle that government supervision must mirror the manner in which companies are managed. The FDIC is concerned that some aspects of this new supervisory approach may detract from achieving the traditional goal of preventing insured entities from supporting risks taken in parents or affiliates. Under an enterprise-wide supervision approach, it appears that the supervisory vision of an insured bank as an independent entity may be supplanted by a supervisory vision of an insured bank as an integrated component of a larger organization. Enterprise supervision by holding company management, and the top-down approach to Basel II advocated by the Federal Reserve, have the potential to call into question the individual accountability of insured institutions owned by large organizations to manage their own capital.

A supervisory goal of insulating an insured bank from risks taken by an affiliate is fundamentally different from a supervisory goal of integrating that bank with its affiliates. Integration downplays the risk-management responsibilities of insured entities operating in financial conglomerates. A supervisory regime that in any way supports the idea that insured banks are not fully accountable for their own risk management, combined with a capital regime that promotes the concept that an insured institution's risk should be measured together with its affiliates, effectively expands the federal safety net.

The regulatory approach of the FDIC focuses on the insured entity and the importance of maintaining corporate separateness. The consolidated supervision model proposed by the GAO for consideration by Congress not only endangers these legal-entity distinctions, but also raises the possibility of extending the federal safety net beyond the insured entity. To the extent banks are integrated and managed as departments of their holding company, especially if regulators by means of their supervisory methodology are actively promoting this approach, there is a danger that the bank could be held liable for the debts or conduct of an affiliate. This piercing of the corporate veil seems far more likely under an "integration" philosophy of supervision than it does under an "insulation" philosophy.

Conclusion

Congress must ensure that a financial regulatory framework is in place that adequately controls the potential cost of the federal banking safety net. This includes deciding how arrangements involving the ownership of banks by commercial firms should be regulated.

The GAO report articulated one vision of such regulation—consolidated banking agency supervision of the commercial parent. We are concerned with such an approach, and we believe the federal safety net is best protected in such situations by a bank-centric regulatory approach that focuses on bank insulation, corporate separateness, and the legal accountability of bank directors and officers.

The FDIC believes these issues will be an important subject for public policy debate in the years ahead. We stand ready to provide the GAO, Congress and other interested persons with any information we can in order to contribute to an appropriate resolution of these important questions.

Sincerely,

Donald E. Powell